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IN THE

Supreme Court of the United States

OCTOBER TERM, 1945

No. 735

DON A. DAVIS,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

Don A. Davis, petitioner, by his attorneys, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Eighth Circuit entered in the above entitled cause on October 15, 1945, affirming the decision of the Tax Court.

Opinion Below

The opinion of the Tax Court (R. 32) is reported in 4 T. C. 329. The opinion of the Circuit Court of Appeals (R. 51) is reported in 151 F. (2d) 441.

Jurisdiction

The judgment of the Circuit Court of Appeals was entered October 15, 1945. The jurisdiction of this Court is

invoked under § 240(a) of the Judicial Code as amended, 28 U. S. C. A. § 347, § 350.

Questions Presented*

1. Whether (a) reasonable underwriters' commissions, and (b) reasonable registration expenses, incurred in the sale of 60,000 shares of petitioner's Western Auto Supply Company stock at a gain are deductible from his gross income as income producing expenses within the meaning of § 23(a)(2) of the Revenue Act of 1936, as amended.

2. Whether such underwriters' commissions and registration expenses incurred in increasing the marketability of petitioner's unsold 108,936 shares of Western Auto Supply Company Stock are deductible from his gross income as management expenses within the meaning of § 23(a)(2) of the Revenue Act of 1936, as amended.

Statutes and Regulations Involved

The statutes and regulations involved are set out in the Appendix, *infra*, pp. 9-23.

Statement

The material facts as found by the Tax Court (R. 32-7) pursuant to stipulation of the parties (R. 22-7) may be summarized as follows:

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*It was in effect conceded below by the Commissioner that the issues in this cause are subject to appellate review upon the merits, no contrary contention having been urged by him in the Circuit Court of Appeals. See *Trust of Bingham* v. *Commissioner*, 325 U. S. 365 (1945).

Petitioner, the taxpayer, is an individual then resident of Mission Hills, Kansas, and he filed his Federal income tax return for the year 1937 with the Collector of Internal Revenue for the Sixth District of Missouri, Kansas City, Missouri (R. 32).

After recapitalization of Western Auto Supply Company, petitioner owned of record 168,936 shares of its new $10 par value common stock (R. 33). Petitioner could not sell his shares of Western Auto Supply Company stock to the general public through underwriters unless a registration statement were in effect under the Securities Act of 1933 (R. 33). Such a registration statement was effected covering 60,000 shares of such stock (R. 33-34) and petitioner paid $5,000.00 as his share of the registration expenses (R. 34).

In order to obtain the best possible price for his shares (R. 35), petitioner entered into an agreement to sell 60,000 of such shares through underwriters (R. 34). The underwriters sold the shares to the general public at a gain to petitioner which was included in his 1937 taxable income and petitioner paid $150,000.00 to the underwriters for their services (R. 34-36).

After sale of the 60,000 shares of such stock by the underwriters, petitioner still owned 108,936 shares of Western Auto Supply Company stock which he held for investment—to collect dividends and to realize gain upon subsequent sale (R. 35). Petitioner engaged the services of underwriters in selling the 60,000 shares to the general public, among other things, to obtain the listing of his unsold Western Auto Supply Company stock on the New York Stock Exchange (R. 36). As a result of such sale to the general public by the underwriters, petitioner's unsold

108,936 shares were listed on the New York Stock Exchange which listing increased their marketability (R. 36).

Both the underwriters' commissions and the registration expenses are reasonable in amount (R. 36).

Specification of Errors to be Urged

The Circuit Court of Appeals erred:

1. In failing to decide that the underwriters' commissions and registration expenses were deductible as "ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income" under §23(a)(2) of the Revenue Act of 1936, as amended.

2. In failing to decide that such underwriters' commissions and registration expenses were deductible as "ordinary and necessary expenses paid or incurred during the taxable year . . . for the management, conservation, or maintenance of property held for the production of income" under §23(a)(2) of the Revenue Act of 1936, as amended.

Reasons for Granting the Writ

1. Section 121 of the Revenue Act of 1942 by retroactive amendment of §23(a)(2) of the Revenue Act of 1936 (and of all Revenue Acts since the Revenue Act of 1913) introduced the principle of allowing as non-trade or non-business expenses in the case of individuals "all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income".

The decision of this Court in *Trust of Bingham* v. *Commissioner,* 325 U. S. 365 (1945), established that management expenses may be deducted even though such expenses were not incurred for the production of income and even though such expenses were incurred in connection with the distribution of the corpus of a trust. The decision of this Court in the *Bingham* case was rendered subsequent to the decision of the Tax Court but prior to the decision of the Circuit Court of Appeals in the instant case.

Petitioner argued in all Courts below that the expenses at bar were deductible within the meaning of §23(a)(2) of the Revenue Act of 1936 because incurred in connection with the management of property held for the production of income. Such property consisted of the 108,936 shares of Western Auto Supply Company stock retained by petitioner for the production of income (R. 25, 35), as distinguished from the 60,000 shares of Western Auto Supply Company stock sold by him. As stipulated by the parties (R. 26) and found as a fact by the Tax Court (R. 36), such expenses increased the marketability of petitioner's 108,936 shares of Western Auto Supply Company stock. Both the Tax Court and the Circuit Court of Appeals ignored petitioner's point that such expenses were properly deductible as having been incurred in connection with the management of his 108,936 shares of Western Auto Supply Company stock which he held for the production of income.

Of course, the Tax Court judge who rendered the decision in the instant case (his decision was not reviewed by the other Tax Court judges) did not have before him for his guidance the decision of this Court in the *Bingham* case. Indeed subsequent to the decision of this Court in the *Bingham* case and in a decision reviewed by all its

judges, the Tax Court has held that at least one of the expenses at bar (Securities and Exchange Commission registration fees) was so clearly deductible under §23(a)(2) as to be "too obvious to merit discussion". *W. N. Fry* v. *Commissioner,* 5 T. C. No. 130 (1945).

It seems apparent that the decisions below by denying the deductibility of the expenses as management expenses have reached a result in the case at bar which is in direct conflict with the decision of this Court in the *Bingham* case. Accordingly, we believe that the case at bar merits issuance of certiorari by this Court because of such conflict alone.

2. In addition, there is an irreconcilable conflict in the decisions of the Circuit Courts of Appeal on the issues here presented. The Ninth Circuit Court of Appeals has affirmed that reasonable expenses of "a purely capital nature" are deductible under § 23(a)(2) although such expenses prior to the enactment of that section had been "repeatedly held . . . capital expenditures and not deductible as ordinary and necessary business expenses". *Walter S. Heller* v. *Commissioner,* 2 T. C. 371, 373-4 (1943), *aff'd,* 147 F. (2d) 376 (C. C. A. 9th, 1945). On the other hand, the Eighth Circuit Court of Appeals in the instant case has ruled that the expenses at bar, having assertedly been held to be non-deductible capital expenditures prior to the enactment of § 23(a)(2), for such reason alone, cannot be deductible under that section even though incurred for the collection or production of income.

It cannot be contended that "income", in connection with which expenses are deductible under § 23(a)(2), has a narrow meaning as contemplated by Congress. The Congressional Reports of both the House and the Senate ex-

plicitly state in identical language that the term "income" as used in § 23(a)(2) "comprehends not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years, and is not confined to recurring income but *applies as well to gain from the disposition of property*". [Italics supplied.] (Appendix, *infra*, pp. 17-23.)

In the circumstances, we believe that the decision below of the Eighth Circuit Court of Appeals is not in accord with the legislative history thus announced and hence is incorrect. This decision directly conflicts with the decision of the Ninth Circuit Court of Appeals in the *Heller* case.

Conclusion

It is therefore respectfully submitted that the petition for a writ of certiorari should be granted.

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January 1946.

APPENDIX

Revenue Act of 1942, c. 619, 56 Stat. 798, amending Revenue Act of 1936, Section 23:

SEC. 121. NON-TRADE OR NON-BUSINESS DEDUCTIONS.

(a) *Deduction for Expenses.*—Section 23(a) (relating to deduction for expenses) is amended to read as follows:

"(a) *Expenses*—

* * * * * * * * *

"(2) *Non-trade or non-business expenses.*—In the case of an individual, all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income."

* * * * * * * * *

(e) *Retroactive Amendment to Prior Revenue Acts.*—For the purposes of the Revenue Act of 1938 or any prior revenue Act the amendments made to the Internal Revenue Code by this section shall be effective as if they were a part of such revenue Act on the date of its enactment.

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

Art. 23(a)-15 (as inserted by T.D. 5196, 1942-2 Cum. Bull. 96, 97-100, and amended by T.D. 5280, 1943 Cum. Bull. 1022, and T.D. 5331, 1944-4 Int. Rev. Bull. 4). *Nontrade or Nonbusiness Expenses.*—(a) *In general.* Subject to the qualifications and limitations in Chapter 1 and particularly in section 24, as amended, an expense may be deducted under section 23(a) (2) only upon the condition that:

(1) it has been paid or incurred by the taxpayer during the taxable year (i) for the production or collection of income which, if and when realized, will be required to be included in income for Federal income tax purposes, or (ii) for the management, conservation, or maintenance of property held for the production of such income; and

(2) it is an ordinary and necessary expense for either or both of the purposes stated in (1) above.

The term "income" for the purpose of section 23(a)(2) comprehends not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years; and is not confined to recurring income but applies as well to gains from the disposition of property. For example, if defaulted bonds, the interest from which if received would be includible in income, are purchased with the expectation of realizing capital gain on their resale, even though no current yield thereon is anticipated, ordinary and necessary expenses thereafter incurred in connection therewith are deductible. Similarly, ordinary and necessary expenses incurred in the management, conservation or maintenance of a building devoted to rental purposes are deductible notwithstanding that there is actually no income therefrom in the taxable year, and regardless of the manner in which or the purpose for which the property in question was acquired. Expenses incurred in managing, conserving, or maintaining property held for investment may be deductible under this provision even though the property is not currently productive and there is no likelihood that the property will be sold at a profit or will otherwise be productive of income and even though the property is held merely to minimize a loss with respect thereto. The expenses, however, of carrying on transactions, which do not constitute a trade

or business of the taxpayer and are not carried on for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income, but which are carried on primarily as a sport, hobby, or recreation are not allowable as nontrade or nonbusiness expenses.

Expenses, to be deductible under section 23(a) (2), must be "ordinary and necessary," which presupposes that they must be reasonable in amount and must bear a reasonable and proximate relation to the production or collection of taxable income or to the management, conservation, or maintenance of property held for the production of income.

(b) Except for the requirement of being incurred in connection with a trade or business, a deduction under this section is subject to all the restrictions and limitations that apply in the case of the deduction under section 23(a) (1) (A) of an expense paid or incurred in carrying on any trade or business. This includes restrictions and limitations contained in section 24, as amended. Section 24 (a) (5), as amended, continues to disallow any amount otherwise allowable as a deduction (whether under section 23(a) (2) or otherwise) which is allocable to one or more classes of tax-exempt income, other than interest, and has the effect in addition of disallowing a deduction under section 23(a) (2) for amounts otherwise allowable under that section which are allocable to tax-exempt interest.

Thus any amount allocable to the production or collection of one or more classes of income which is not includible in gross income or to the management, conservation or maintenance of property held for the production of such income is not deductible under section 23(a) (2). Nor does section 23(a) (2) allow any expenses which are disallowed by any of the provisions of Chapter 1 of the Code.

Capital expenditures, and expenses of carrying on transactions which do not constitute a trade or business of the taxpayer and are not carried on for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income, but which are carried on primarily as a sport, hobby, or recreation are not allowable as nontrade or nonbusiness expenses. The question whether or not a transaction is carried on primarily for the production of income or for the management, conservation, or maintenance of property held for the production or collection of income, rather than primarily as a sport, hobby, or recreation, is not to be determined solely from the intention of the taxpayer but rather from all the circumstances of the case, including the record of prior gain or loss of the taxpayer in the activity, the relation between the type of activity and the principal occupation of the taxpayer, and the uses to which the property or what it produces is put by the taxpayer.

Among expenditures not allowable under section 23(a) (2) are the following: Commuters' expenses; expenses of taking special courses or training; expenses for improving personal appearance; the cost of rental of a safe-deposit box for storing jewelry and other personal effects; and expenses such as expenses in seeking employment or in placing oneself in a position to begin rendering personal services for compensation, campaign expenses of a candidate for public office, bar examination fees and other expenses incurred in securing admission to the bar, and corresponding fees and expenses incurred by physicians, dentists, accountants, and other taxpayers for securing the right to practice their respective professions.

Fees for services of investment counsel, custodian fees, clerical help, office rent, and similar expenses paid or incurred by a taxpayer in connection with investments held by him are deductible under section 23(a)

(2) only if (1) they are paid or incurred by the taxpayer for the production or collection of income, or for the management, conservation, or maintenance of investments held by him for the production of income; and (2) they are ordinary and necessary under all the circumstances, having regard to the type of investment and to the relation of the taxpayer to such investment.

Ordinary and necessary expenses paid or incurred in connection with the management, conservation, or maintenance of property held for use as a residence by the taxpayer are not deductible. However, ordinary and necessary expenses paid or incurred in connection with the management, conservation, or maintenance of property held by the taxpayer as rental property are deductible even though such property was formerly held by the taxpayer for use as a home.

Expenditures incurred by an administrator or executor in securing the processes and orders of the court having jurisdiction over the probate of the estate, or in collecting the assets of the estate (other than income which, if and when realized, must be reported by the estate for income tax purposes), or in adjusting claims against the decedent, or in distributing the remaining assets to the beneficiaries, or in conserving the assets for ultimate distribution to the parties entitled thereto, are not deductible under this section. Ordinary and necessary expenses, however, which are paid or incurred during the taxable year by an administrator or executor for the production or collection of income which, if and when realized, must be reported by the estate for income-tax purposes, such as fees for collecting rents on property in the estate of the decedent, or for collecting interest or dividends on securities in that estate, or which are paid or incurred during the taxable year for the management, conservation, or maintenance of property in the estate of the decedent held for the production of income, the income from which, if and when

realized must be reported by the estate for income tax purposes, such as expenditures for insurance or repairs, or expenditures of a similar nature, are deductible under this section at the option of the taxpayer notwithstanding that deductions therefor are allowable under section 812(b) in computing the gross estate subject to the estate tax, provided the requisite statement and waiver are filed. (See section 162(e).)

The ordinary expenditures of administration incurred in a receivership or bankruptcy proceeding are not deductible. Such expenditures include expenditures incurred in the performance of the ordinary duties of a receiver or trustee in bankruptcy, as, for example, fees paid to the attorney for the petitioning creditors, fees paid to the appraisers, and disbursements which are made in connection with the proceeding and which look toward the collection of the assets and their preservation pending ultimate distribution to the parties entitled thereto.

Reasonable amounts paid or incurred by a trustee on account of trustees' fees and other expenses which are ordinary and necessary in connection with the production or collection of trust income or with the management, conservation, or maintenance of trust property held for the production of income are deductible, notwithstanding that the trust is not engaged in a trade or business.

Reasonable amounts paid or incurred for the services of a guardian or committee for a ward or minor, and other expenses of guardians and committees which are ordinary and necessary, in connection with the production or collection of income inuring to the ward or minor, or in connection with the management, conservation, or maintenance of property, held for the production of income, belonging to the ward or minor, are deductible.

It is immaterial whether the expenses of fiduciaries are paid from the corpus of the estate or from income.

Expenses derive their character not from the fund from which they are paid, but from the purposes for which they are incurred.

Expenditures incurred in defending or perfecting title to property, in recovering property (other than investment property and amounts of income which, if and when recovered, must be included in income), or in developing or improving property, constitute a part of the cost of the property and are not deductible expenses. Attorneys' fees paid in a suit to quiet title to lands are not deductible; but if the suit is also to collect accrued rents thereon, that portion of such fees is deductible which is properly allocable to the services rendered in collecting such rents. Expenditures incurred in protecting or asserting one's rights to property of a decedent as heir or legatee, or as beneficiary under a testamentary trust, are not deductible expenses. Expenditures incurred for the purpose of preparing tax returns (except to the extent such returns relate to taxes on property held for the production of income), for the purpose of recovering taxes (other than recoveries required to be included in income), or for the purpose of resisting a proposed additional assessment of taxes (other than taxes on property held for the production of income) are not deductible expenses under this section, except that part thereof which the taxpayer clearly shows to be properly allocable to the recovery of interest required to be included in income.

The deduction of an item otherwise allowable under section 23(a) (2) will not be disallowed simply because the taxpayer also had an election under chapter 1 to treat it as a capital expenditure, rather than to deduct it as an expense. (See section 24(a)(7), added by section 130(a) of the Revenue Act of 1942.) Where, however, the item may properly be treated only as a capital expenditure or where it was properly so treated under an option granted in chapter 1, no deduction is

allowable under this section; and this is true regardless of whether any basis adjustment is allowed under section 113.

(c) The provisions of section 23(a) (2) are not intended in any way to disallow expenses which would otherwise be allowable under section 23(a) (1) or the regulations applicable thereto, or under any other section of the Internal Revenue Code or the regulations applicable thereto. Double deductions are not permitted. Amounts deducted under one provision of the Internal Revenue Code can not again be deducted under any other provision thereof.

Art. 24-2. *Capital expenditures.*—Amounts paid for increasing the capital value or for making good the depreciation (for which a deduction has been made) of property are not deductible from gross income. (See section 23(l).). Amounts expended for securing a copyright and plates, which remain the property of the person making the payments, are investments of capital. The cost of defending or perfecting title to property constitutes a part of the cost of the property and is not a deductible expense. The amount expended for architects' services is part of the cost of the building. Commissions paid in purchasing securities are a part of the cost price of such securities. Commissions paid in selling securities, when such commissions are not an ordinary and necessary business expense, are an offset against the selling price. Expenses of the administration of an estate, such as court costs, attorneys' fees, and executors' commissions, are chargeable against the corpus of the estate and are not allowable deductions. Amounts to be assessed and paid under an agreement between bondholders or shareholders of a corporation, to be used in reorganization of the corporation, are investments of capital and not deductible for any purpose in returns of income. (See article 22(a)-17.)

An assessment paid by a shareholder of a national bank on account of his statutory liability is ordinarily not deductible but, subject to the provisions of the Act, may in certain cases represent a loss. Expenses of the organization, of a corporation, such as incorporation fees, attorneys' and accountants' charges, are capital expenditures and not deductible from gross income. A holding company which guarantees dividends at a specified rate on the stock of a subsidiary corporation for the purpose of securing new capital for the subsidiary and increasing the value of its stock holdings in the subsidiary may not deduct amounts paid in carrying out this guaranty in computing its net income, but such payments may be added to the cost of its stock in the subsidiary.

H. R. Rep. No. 2333, 77th Cong., 2d Sess., pp. 46, 74-76 (1942-2 Cum. Bull. 372, 410, 429):

6. NONTRADE OR NONBUSINESS DEDUCTIONS

The existing law allows taxpayers to deduct expenses incurred in connection with a trade or business. Due partly to the inadequacy of the statute and partly to court decisions, nontrade or nonbusiness expenses are not deductible, although nontrade or nonbusiness income is fully subject to tax. The bill corrects this inequity by allowing all of the ordinary and necessary expenses paid or incurred for the production or collection of income or for the management, conservation or maintenance of property held for the production of income. Thus, whether or not the expense is in connection with the taxpayer's trade or business, if it is expended in the pursuit of income or in connection with property held for the production of income, it is allowable.

SECTION 118. NONTRADE OR NONBUSINESS DEDUCTIONS

This amendment allows a deduction for the ordinary and necessary expenses of an individual paid or incurred during the taxable year for the production and collection of income, or for the management, conservation, or maintenance of property held by the taxpayer for the production of income, whether or not such expenses are paid or incurred in carrying on a trade or business, and also allows a deduction for the exhaustion and wear and tear (including a reasonable amount for obsolescence) on property held for the production of income, whether or not such property is used by the taxpayer in a trade or business.

For an expense to be deductible under this section, it must have been incurred either (1) for the production or collection of income, or (2) for the management, conservation, or maintenance of property held for the production of income. Ordinary and necessary expenses so paid or incurred are deductible under section 23(a)(2) even though they are not paid or incurred for the production or collection of income of the taxable year or for the management, conservation, or maintenance of property held for the production of such income. The term "income" for this purpose comprehends not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years, and is not confined to recurring income but applies as well to gain from the disposition of property. Expenses incurred in managing or conserving property held for investment may be deductible under this provision even though there is no likelihood that the property will be sold at a profit or will otherwise be productive of income. The expenses, however, of carrying on a transaction which does not constitute a trade or business of the taxpayer and is not carried on for the production of income or for the management, con-

servation, or maintenance of property, but which is carried on primarily as a sport, hobby, or recreation are not allowable as nontrade or nonbusiness expenses.

Expenses to be deductible under Section 23(a)(2), must be ordinary and necessary, which rule presupposes that they must be reasonable in amount and must bear a reasonable and proximate relation to the production or collection of income, or to the management, conservation, or maintenance of property held for that purpose.

A deduction under this section is subject, except for the requirement of being incurred in connection with a trade or business, to all the restrictions and limitations that apply in the case of the deduction under section 23(a)(1)(A) of an expense paid or incurred in carrying on any trade or business. Section 24(a)(5), as amended by this section, while continuing to disallow any amount allowable as a deduction, whether under section 23(a)(2) or otherwise, which is allocable to one or more cases of tax-exempt income, other than interest, has the effect in addition of disallowing a deduction under section 23(a)(2) for amounts allowable under that section which are allocable to tax-exempt interest.

Expenses incurred by an administrator or executor in the administration of the estate of a decedent, such, for example, as expenses in securing the processes and orders of the court having jurisdiction over the probate of an estate, or in adjusting claims against the estate, or in distributing the remaining assets to the beneficiaries, are not deductible under this section. Ordinary and necessary expenses, however, which are paid or incurred during the taxable year by an administrator or an executor for the production or collection of income which must be reported by the estate for income tax purposes, may be claimed as deductions under this section notwithstanding that deductions therefor are allowable under

section 812(b) in computing the gross estate subject to the estate tax. Accordingly, subsection (c) of this section amends section 162 to provide that no deduction shall be allowed under section 23(a) (2) in computing the net income of the estate for amounts for which there may have been or has already been allowed a deduction under section 812(b) in computing the net estate of the decedent. The present amendment would not allow as a deduction under section 23(a) (2) for income tax purposes any amount which is allowable under section 812(b) as a deduction in computing the net estate of a decedent for estate tax purposes, unless the Commissioner receives a statement, filed within the time and in the manner and form prescribed by him, to the effect that the amount in question has not been claimed or allowed as a deduction under section 812(b) and that the right to have such items allowed at any time as a deduction under section 812(b) is waived.

Subsection (d) of this section amends section 23(1) of the Internal Revenue Code so as to allow, in addition to the deduction allowable under the existing law, a deduction for the exhaustion, wear and tear of property held by the taxpayer for the production of income whether or not the property in question is used in the trade or business of the taxpayer, including a reasonable allowance for obsolescence. Except for this, the new allowance is subject to the same limitations and restrictions which have been applicable under this section prior to the present amendment.

The amendments made to the Internal Revenue Code by this section are applicable to all taxable years beginning after December 31, 1938. These amendments shall also be effective as if they were a part of the Revenue Act of 1938 or any prior revenue act on the date of its enactment.

Sen. Rep. No. 1631, 77th Cong. 2d Sess., pp. 87-88 (1942-2 Cum. Bull. 504, 570):

SECTION 121. NON-TRADE OR NON-BUSINESS DEDUCTIONS.

This section is the same as section 118 of the House Bill except that subsection (c) of that section has been omitted therefrom and now appears as section 163 and a clerical amendment has been made in subsection (b). The amendemnt made by this section allows a deduction for the ordinary and necessary expenses of an individual paid or incurred during the taxable year for the production and collection of income, or for the management, conservation, or maintenance of property held by the taxpayer for the production of income, whether or not such expenses are paid or incurred in carrying on a trade or business, and also allows a deduction for the exhaustion and wear and tear (including a reasonable amount for obsolescence) on property held for the production of income whether or not such property is used by the taxpayer in a trade or business.

For an expense to be deductible under this section, it must have been incurred either (1) for the production or collection of income, or (2) for the management, conservation, or maintenance of property held for the production of income. Ordinary and necessary expenses so paid or incurred are deductible under section 23(a) (2) even though they are not paid or incurred for the production or collection of income of the taxable year or for the management, conservation, or maintenance of property held for the production of such income. The term "income" for this purpose comprehends not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years, and is not confined to recurring income but applies as well to gain from the disposition of property. Expenses incurred in managing or conserving property held for investment may be deductible under this provision even though there is no likelihood that the property will be sold at a profit or

will otherwise be productive of income, and even though the property is held merely to minimize a loss with respect thereto. The expenses, however, of carrying on a transaction which does not constitute a trade or business of the taxpayer and is not carried on for the production of income or for the management, conservation, or maintenance of property, but which is carried on primarily as a sport, hobby, or recreation are not allowable as non-trade or non-business expenses.

Expenses, to be deductible under section 23(a)(2), must be ordinary and necessary, which rule presupposes that they must be reasonable in amount and must bear a reasonable and proximate relation to the production or collection of income, or to the management, conservation, or maintenance of property held for that purpose.

A deduction under this section is subject, except for the requirement of being insured in connection with a trade or business, to all the restrictions and limitations that apply in the case of the deduction under section 23(a)(1)(A) of an expense paid or incurred in carrying on any trade or business. Section 24(a)(5), as amended by this section, while continuing to disallow any amount allowable as a deduction, whether under section 23(a)(2) or otherwise, which is allocable to one or more classes of tax-exempt income, other than interest, has the effect in addition of disallowing a deduction under section 23(a)(2) for amounts allowable under that section which are allocable to tax-exempt interest.

Subsection (c) of this section amends section 23(1) of the Code so as to allow, in addition to the deduction allowable under the existing law, a deduction for the exhaustion, wear, and tear of property held by the taxpayer for the production of income, whether or not the property in question is used in the trade or business of the taxpayer, including a reasonable allowance

for obsolescence. Except for this the new allowance is subject to the same limitations and restrictions which have been applicable under this section prior to the present amendment.

The amendments made to the Code by this section are applicable to all taxable years beginning after December 31, 1938. These amendments shall also be effective as if they were a part of the Revenue Act of 1938 or any prior revenue act on the date of its enactment.

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In the Supreme Court of the United States

OCTOBER TERM, 1945

No. 735

DON A. DAVIS, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 32–39) are reported in 4 T. C. 329. The opinion of the Circuit Court of Appeals (R. 51–56) is reported in 151 F. 2d 441.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on October 15, 1945 (R. 56–57). The petition for a writ of certiorari was filed on January 12, 1946. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the taxpayer is entitled, under Section 23 (a) (2) of the Revenue Act of 1936, as amended by Section 121 of the Revenue Act of 1942, to deduct selling commissions and registration expenses as ordinary and necessary expenses or whether such sums are capital expenditures, and so not deductible from gross income.

STATUTE AND OTHER AUTHORITIES INVOLVED

The applicable statute and other authorities involved are set out in the Appendix, *infra*, pp. 11–20.

STATEMENT

The findings of the Tax Court, so far as pertinent here, are as follows:

On January 1, 1916, the petitioner purchased the controlling interest in the Western Auto Supply Company, a Missouri corporation organized in 1914, and has been its principal stockholder and officer since 1916. At the beginning of the year 1937, this company had outstanding 130,456 shares of no par, nonvoting Class A common stock and 100,000 shares of no par, voting Class B common stock. The latter stock was never listed or admitted to trading on any stock exchange. In March, 1928, the Class A common stock was admitted to unlisted trading privileges and was bought and sold on the New York Curb Exchange

up to and including the month of April, 1937. (R. 32–33.)

On April 5, 1937, the petitioner owned of record, 14,845 shares of the Class A common stock and 41,467 shares of the Class B common stock. He could not sell this stock to the general public through an underwriter or distributor of securities unless a registration statement was in effect with respect to such shares since, due to the Securities Act of 1933, no underwriter would purchase such shares for resale, in view of the petitioner's voting power (right to vote for election of directors of Western Auto). (R. 33.)

On or about April 5, 1937, Western Auto was recapitalized under a plan whereby each share of its outstanding stock, consisting of Class "A" and Class "B" common stock, was converted into three shares of new common stock having a par value of $10. On or about March 4, 1937, there was filed with the Securities and Exchange Commission, Washington, D. C., a registration statement covering 126,000 shares of the above-mentioned new $10 par common stock of Western Auto, and pursuant to subsequent amendments to this statement the registration was effected. The petitioner owned 60,000 of the shares covered by the registration. (R. 33–34.)

During the taxable year 1937, the petitioner paid Western Auto $5,000, which was his portion

of the following expenses incurred in connection with the registration of the shares (R. 34):

Counsel fees	$10,000.00
Fee of Auditors	2,000.00
S. E. C. registration fee	367.50
Registration or qualification under State Blue Sky laws	3,000.00
Printing	6,000.00
Miscellaneous expenses, including postage, telephone and telegraph charges, traveling expenses and other out-of-pocket expenses	6,000.00

Pursuant to a contract dated March 31, 1937, the petitioner engaged the services of a group of underwriters to offer to the public, at $28.75 per share, the 60,000 shares referred to above. When such offering was made shortly thereafter it was subscribed in full. (R. 34.)

On or about April 13, 1937, a representative of the several underwriters delivered to Bankers Trust Company (the stock transfer agent) checks drawn to the petitioner's order in the aggregate amount of $1,725,000. Simultaneously therewith, Bankers Trust Company delivered a check for $150,000 for services rendered by the underwriters in connection with the offering of stock to the public. (R. 34–35.)

Immediately after the sale of this stock, the petitioner owned 108,936 shares of the common stock of Western Auto which he held for investment with a view to collecting dividends therefrom and to realize gain if subsequently sold. The petitioner also sold his shares of Western Auto stock and paid the commissions to the under-

writers for their services in order to obtain the best possible price for such stock. (R. 35.)

In computing capital gain for his 1937 tax return, the petitioner did not reduce the sales price or increase the cost basis of the stock sold by subtracting the $150,000 paid to the underwriters as commissions and the $5,000 paid as his allocated part of the cost of the registration. Instead, he claimed both sums as deductions in computing ordinary net income. It is agreed that the cost basis of this stock is $368,770; and if the $155,000 is deductible as an ordinary and necessary non-business expense incurred in the production of income or in the management of property held for the production of income, the amount of the capital gain resulting from the sale of the stock is $1,356,230. But if the sum of $155,000 is either a part of the petitioner's cost or an offset against the sales price in computing his capital gain, it is agreed that the amount of capital gain resulting from the sale of the stock is $1,201,230. (R. 35–36.)

On June 3, 1937, because of the sale of stock by the underwriters to the general public, Western Auto stock was admitted to listing on the New York Stock Exchange. Such listing increased the marketability thereof, for on January 6, 1937, there were only 780 holders of the stock of Western Auto whereas at the close of business on January 29, 1938, there were 2,174 holders of the new stock. (R. 36.)

The Tax Court held that the sums of $150,000 and $5,000, referred to, are not deductible as ordinary and necessary nonbusiness expenses incurred for the production of income. Accordingly, it decided that there is a deficiency in income tax for 1937 in the amount of $86,489.24. (R. 40).

The decision of the Tax Court was affirmed (R. 56–57).

ARGUMENT

The petitioner asserts the right to deduct the sums involved here as nonbusiness or nontrade expenses under Section 23 (a) (2) of the Revenue Act of 1936, as retroactively amended by the Revenue Act of 1942 (Appendix, *infra*, p. 11). Under that Section, expenses must not only be paid or incurred, as petitioner contends, for the production or collection of income, or for the management, conservation or maintenance of property held for the production of income, but such expenses must also be "ordinary and necessary expenses."

The term "ordinary and necessary expenses" has appeared in the provisions of all of the revenue statutes allowing the deduction of business expenses and its meaning was well established before 1942. Thus it had been authoritatively settled, before the enactment of Section 23 (a) (2), that such term does not include capital expenditures and that expenses like those here are capital expenditures. As to commissions, see *Spreckels* v.

Helvering, 315 U. S. 626; *Helvering* v. *Winmill,* 305 U. S. 79, and *Helvering* v. *Union Pacific Co.,* 293 U. S. 282. Also see Article 24–2 of Treasury Regulations 94 and G. C. M. 15430 (Appendix, *infra,* pp. 14–15, 17–20). As to registration costs, see *Motion Picture Capital Corp.* v. *Commissioner,* 80 F. 2d 872 (C. C. A. 2d), and I. T. 3026, XV–2 Cum. Bull. 83 (1936).

In using the term "ordinary and necessary expenses" in Section 23 (a) (2), Congress did not enlarge or change its generally accepted meaning. *Bowers* v. *Lumpkin,* 140 F. 2d 927 (C. C. A. 4th), certiorari denied, 322 U. S. 755. In enacting that Section, Congress was adopting a proposal of the Treasury Department "to afford relief for a specifically defined inequitable situation which had become manifest" by the decision in *Higgins* v. *Commissioner,* 312 U. S. 212, and definitely intended the amendment to be "for the restricted purpose which originated it." *McDonald* v. *Commissioner,* 323 U. S. 57, 61, 62.

This is further shown by the legislative reports on this amendment in which it was specifically pointed out that a deduction thereunder would be subject, except for the requirement of being incurred in a trade or business, to all the restrictions and limitations that apply in case of a deduction under the section covering business expenses. See H. Rep. No. 2333 and S. Rep. No. 1631 (Appendix, *infra,* pp. 16, 17). Consequently, as this

Court stated in *McDonald* v. *Commissioner,* 323 U. S. at p. 62, the 1942 amendment "merely enlarged the category of incomes with reference to which expenses were deductible." It does not permit the deduction of capital expenditures.

In urging such a radical departure in the interpretation of the term "ordinary and necessary expenses," the petitioner relies on *Trust of Bingham* v. *Commissioner,* 325 U. S. 365, with which he asserts a conflict here. That case involved certain legal expenses which the Tax Court found to be ordinary and necessary expenses for the management or conservation of the trust property; and the question on appeal was whether such expenses were incurred for the production of income or in the management of property held for the production of income. In holding that the expenses were so incurred, this Court specifically pointed out that to be deductible under Section 23 (a) (2) they must be ordinary and necessary expenses. It also stated (pp. 373–374) that Section 23 (a) (2) is "comparable and *in pari materia*" with the provision authorizing business expenses, and that "the effect of section 23 (a) (2) was to provide for a class of non-business deductions coextensive with the business deductions." We submit that the decision of the court below is not in conflict with the *Bingham* case.

Petitioner also asserts a conflict with *Heller* v. *Commissioner,* 147 F. 2d 376 (C. C. A. 9th), cer-

tiorari denied on another issue, 325 U. S. 868. It was held there that attorneys' fees paid in connection with a suit for the cash value of certain stock were deductible under Section 23 (a) (2), here involved. However, such fees were not treated as capital expenditures; the Tax Court had found that the suit was not one to defend or assert title to property, but was for the production or collection of income. The Circuit Court of Appeals treated the question as one of fact, and having accepted the findings of the Tax Court, it affirmed the latter's decision to permit the deduction. Accordingly, in view of the findings of the Tax Court in that case, there is nothing in the holding in the *Heller* case essentially in conflict with the decision here.

Petitioner's alternative argument that the underwriters' commissions and the registration fees were ordinary and necessary expenses within the meaning of Section 23 (a) (2) "because incurred in connection with the management of property [the retained shares] held for the production of income" (Pet. 5) is, at best, a strained attempt to avoid the essential capital nature of the expenses of sale by attributing those expenses to the marketability of the retained shares and assuming, without discussion, that, so viewed, they were not capital expenditures. Even if sound, this contention can afford no aid to the petitioner here since he has laid no foundation

for the proration of expenses which would undoubtedly be required. Cf. *Helvering* v. *Stormfeltz,* 142 F. 2d 982, 984–985 (C. C. A. 8th).

CONCLUSION

For the foregoing reasons, review by this Court is not warranted.

Respectfully submitted.

J. HOWARD MCGRATH,
Solicitor General.

SEWALL KEY,
Acting Assistant Attorney General.

J. LOUIS MONARCH,
LOUISE FOSTER,
Special Assistants to the Attorney General.

FEBRUARY 1946.

APPENDIX

Revenue Act of 1942, c. 619, 56 Stat. 798:

> SEC. 121. NON-TRADE OR NON-BUSINESS DEDUCTIONS.
>
> (a) *Deduction for Expenses.*—Section 23 (a) (relating to deduction for expenses) is amended to read as follows:
>
> "(a) *Expenses.*—
>
> * * * * *
>
> "(2) *Non-Trade or Non-Business Expenses.*—In the case of an individual, all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income."
>
> * * * * *
>
> (e) *Retroactive Amendment to Prior Revenue Acts.*—For the purposes of the Revenue Act of 1938 or any prior revenue Act the amendments made to the Internal Revenue Code by this section shall be effective as if they were a part of such revenue Act on the date of its enactment. (26 U. S. C., Supp. IV, Sec. 23.)

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

> ART. 23 (a)–15 [as added by T. D. 5196, 1942–2 Cum. Bull. 96, 97–100 [1]]. *Nontrade*

[1] This article was also amended by T. D. 5280, 1943 Cum. Bull. 1022, and T. D. 5331, 1944 Cum. Bull. 98, but such amendments are in no respect material here.

or Nonbusiness Expenses.—(a) *In general.*—Subject to the qualifications and limitations in Chapter 1 and particularly in section 24, as amended, an expense may be deducted under section 23 (a) (2) only upon the condition that:

(1) it has been paid or incurred by the taxpayer during the taxable year (i) for the production or collection of income which, if and when realized, will be required to be included in income for Federal income tax purposes, or (ii) for the management, conservation, or maintenance of property held for the production of such income; and

(2) it is an ordinary and necessary expense for either or both of the purposes stated in (1) above.

The term "income" for the purpose of section 23 (a) (2) comprehends not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years; and is not confined to recurring income but applies as well to gains from the disposition of property. For example, if defaulted bonds, the interest from which if received would be includible in income, are purchased with the expectation of realizing capital gain on their resale, even though no current yield thereon is anticipated, ordinary and necessary expenses thereafter incurred in connection therewith are deductible. * * *

Expenses, to be deductible under section 23 (a) (2), must be "ordinary and necessary," which presupposes that they must be reasonable in amount and must bear a reasonable and proximate relation to the

production or collection of taxable income or to the management, conservation, or maintenance of property held for the production of income.

(b) Except for the requirement of being incurred in connection with a trade or business, a deduction under this section is subject to all the restrictions and limitations that apply in the case of the deduction under section 23 (a) (1) (A) of an expense paid or incurred in carrying on any trade or business. * * *

Capital expenditures, and expenses of carrying on transactions which do not constitute a trade or business of the taxpayer and are not carried on for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income, but which are carried on primarily as a sport, hobby, or recreation are not allowable as nontrade or nonbusiness expenses.

* * * * *

Expenditures incurred in defending or perfecting title to property, in recovering property (other than investment property and amounts of income which, if and when recovered, must be included in income), or in developing or improving property, constitute a part of the cost of the property and are not deductible expenses. Attorneys' fees paid in a suit to quiet title to lands are not deductible; but if the suit is also to collect accrued rents thereon, that portion of such fees is deductible which is properly allocable to the services rendered in collecting such rents. Expenditures incurred in protecting or asserting one's rights to property of a decedent as heir or

legatee, or as beneficiary under a testamentary trust, are not deductible expenses. Expenditures incurred for the purpose of preparing tax returns (except to the extent such returns relate to taxes on property held for the production of income), for the purpose of recovering taxes (other than recoveries required to be included in income), or for the purpose of resisting a proposed additional assessment of taxes (other than taxes on property held for the production of income) are not deductible expenses under this section, except that part thereof which the taxpayer clearly shows to be properly allocable to the recovery of interest required to be included in income.

* * * * *

PAR. 10. Pursuant to the above provision of law, the amendments to sections 19.23 (a)–15, 19.23 (l)–1, 2, and 3, and 19.24–4 of Regulations 103 set forth in this Treasury decision (which regulations cover taxable years beginning after December 31, 1938), are hereby made applicable to taxable years beginning prior to January 1, 1939 (such years being covered by Regulations 101, 94, 86, 77, 74, 69, 65, 62, 45, and 33).

* * * * *

ART. 24–2. *Capital expenditures.*— * * * The cost of defending or perfecting title to property constitutes a part of the cost of the property and is not a deductible expense. The amount expended for architects' services is part of the cost of the building. Commissions paid in purchasing securities are a part of the cost price of such securities. Commissions paid in selling securities, when such commissions are not an

ordinary and necessary business expense,[2] are an offset against the selling price. Expenses of the administration of an estate, such as court costs, attorneys' fees, and executors' commissions, are chargeable against the corpus of the estate and are not allowable deductions. Amounts to be assessed and paid under an agreement between bondholders or shareholders of a corporation, to be used in a reorganization of the corporation, are investments of capital and not deductible for any purpose in returns of income. * * *

H. Rep. No. 2333, 77th Cong., 2d Sess., pp. 46, 74–75 (1942–2 Cum. Bull. 372, 410, 429–430):

6. NONTRADE OR NONBUSINESS DEDUCTIONS

The existing law allows taxpayers to deduct expenses incurred in connection with a trade or business. Due partly to the inadequacy of the statute and partly to court decisions, nontrade or nonbusiness expenses are not deductible, although nontrade or nonbusiness income is fully subject to tax. The bill corrects this inequity by allowing all of the ordinary and necessary expenses paid or incurred for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income. Thus, whether or not the expense is in connection with the taxpayer's trade or business, if it is expended in the pursuit of income or in connection with property held for the production of income, it is allowable.

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[2] See explanation of this clause given in G. C. M. 15430, below, which was approved by this Court in *Spreckels* v. *Helvering*, 315 U. S. 626.

SECTION 118. NONTRADE OR NONBUSINESS DEDUCTIONS.

* * * * *

For an expense to be deductible under this section, it must have been incurred either (1) for the production or collection of income, or (2) for the management, conservation, or maintenance of property held for the production of income. Ordinary and necessary expenses so paid or incurred are deductible under section 23 (a) (2) even though they are not paid or incurred for the production or collection of income of the taxable year or for the management, conservation, or maintenance of property held for the production of such income. The term "income" for this purpose comprehends not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years, and is not confined to recurring income but applies as well to gain from the disposition of property. Expenses incurred in managing or conserving property held for investment may be deductible under this provision even though there is no likelihood that the property will be sold at a profit or will otherwise be productive of income.

* * * * *

A deduction under this section is subject, except for the requirement of being incurred in connection with a trade or business, to all the restrictions and limitations that apply in the case of the deduction under section 23 (a) (1) (A) of an expense paid or incurred in carrying on any trade or business.

* * * * *

S. Rep. No. 1631, 77th Cong., 2d Sess., pp. 87–88 (1942–2 Cum. Bull. 504, 570–571), contains an explanation of the statutory provisions involved in the instant case which is almost identical with H. Rep. No. 2333, *supra*.

G. C. M. 15430, XIV–2 Cum. Bull. 59–61 (1935):

> An opinion is requested whether commissions paid in connection with sales of securities are deductible as ordinary and necessary business expenses under section 23 (a) of the Revenue Act of 1934, or whether they should be used as an offset against the selling price of the securities in computing gain or loss.
>
> The question as to the deductibility of such commissions involves three classes of taxpayers—(1) a dealer in securities, (2) a trader in securities, and (3) a taxpayer who purchases and sells securities occasionally but not in such quantities or under such circumstances as to constitute him either a dealer or a trader. * * *
>
> * * * The position of the Treasury Department, which has been in effect for many years, is expressed by paragraph 108 of Regulations 33, revised, construing the Revenue Act of 1916, which provides that:
>
> "*Expense—Commissions paid.*—Commissions paid in purchasing and selling securities are a part of the cost or selling price of the securities and not otherwise deductible. They do not constitute expense deductions in a return of income."
>
> Article 293 of Regulations 45 reads in part as follows:
>
> "* * * Commissions paid in purchasing securities are a part of the cost price of such securities. Commissions paid in sell-

ing securities are an offset against the selling price. * * *"

The same language appears in article 293 of Regulations 62, article 292 of Regulations 65, article 292 of Regulations 69, and article 282 of Regulations 74. Article 282 of Regulations 77 and article 24–2 of Regulations 86 read in part as follows:

"* * * Commissions paid in purchasing securities are a part of the cost price of such securities. Commissions paid in selling securities, *when such commissions are not an ordinary and necessary business expense,* are an offset against the selling price. * * *" [Italics supplied.]

The language of all the Revenue Acts from the Revenue Act of 1913 to and including the Revenue Act of 1934 is substantially identical in so far as the provisions affecting the present issue are concerned. It is well settled that where a statute has been construed for a long period of time as having a certain meaning, a reenactment of that statute without change indicates legislative sanction of the construction previously given it.

* * * * *

Since, fundamentally, commissions on both purchases and sales are direct charges to the profit or loss arising from the particular sales in connection with which they are paid, there can be no justification for a departure from that method of treatment except in those cases where the detail of accounting on that basis is so burdensome as to make its use impracticable. No such accounting difficulties exist in the case of any of the three classes of taxpayers enumerated above except the *dealer.* Both the occasional seller and the trader are re-

quired to account in their income tax returns for the profit or loss on each individual sale. The right to inventory securities is denied to the trader and to the occasional seller. (See article 22 (c)–5, Regulations 86.) In so accounting, no difficulty whatever is experienced in adding the purchase commission to the cost of the security and deducting the sale commission from the selling price thereof. In the case of the dealer, no accounting difficulty is experienced in adding the purchase commission to the cost and he is required to do so in all cases instead of treating such commissions as current expenses even where he is permitted to inventory his securities. However, in the dealer's accounting there are difficulties which make it impracticable for him to match his selling commissions against each individual sale. The dealer usually buys in large quantities, his sales are numerous and in relatively small amounts, his commissions are often computed and paid on a volume of sales instead of on individual transactions, and where he uses inventories he necessarily departs widely from the principle of accounting for the profit on each individual purchase and sale. The Commissioner has recognized these difficulties and in actual practice has permitted the dealer in securities to treat his selling commissions as "ordinary and necessary business expenses," not because they are technically such but because of practical considerations. However, no formal recognition was given this practice until the promulgation of Regulations 77, when, in article 282, there was inserted the qualifying phrase "when such commissions are not an ordinary and necessary business expense." This language should not be

construed as holding that selling commissions are to a trader "ordinary and necessary expenses * * * in carrying on any trade or business" within the meaning of section 23 (a) of the Revenue Act of 1934 and corresponding provisions of prior Revenue Acts.

* * * * *

It is concluded, therefore, that buying commissions are a part of the cost of securities and are not deductible as ordinary and necessary business expenses. Selling commissions are an offset against the sale price and are not deductible as ordinary and necessary business expenses, except in the case of a dealer in securities.

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